No. 22,496

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

GYRO ENGINEERING CORPORATION, a
California corporation,

Appellant

v.

UNITED STATES OF AMERICA,

Appellee

ON APPEAL FROM THE JUDGMENT OF THE DISTRICT COURT OF THE
UNITED STATES FOR THE CENTRAL DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLEE

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Miscellaneous:

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OPINION BELOW

The opinion of the District Court (II-R. 706-750) is officially reported at 276 F. Supp. 454 (C. D. Calif. 1967).

JURISDICTION

This appeal involves federal income taxes for the taxable years 1959 and 1960 in the respective amounts of $54,891.92 (I-R. 2-5) and $48,386.06 (I-R. 6-8). The taxes in dispute were paid on April 30, 1964. (I-R. 92.) Claim for refund was filed

on October 5, 1964, and was rejected on August 25, 1965. (I-R. 92-93.) Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on August 2, 1965, the taxpayer brought this action in the District Court for recovery of the taxes paid. (I-R. 2-8, 93.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346(a)(1) and Section 1402(a)(2). The judgment of the District Court was entered on October 19, 1967. (II-R. 752.) Within sixty days thereafter, on November 2, 1967, a notice of appeal was filed. (II-R. 754.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

Whether the record warrants the District Court's conclusion that a 1959 transfer of depreciable properties to the taxpayer corporation by its controlling stockholders was in substance a contribution to its capital, not a _bona fide_ sale; and that consequently (1) the taxpayer's basis for depreciation of the properties for federal income tax purposes was limited by Section 362 (a)(2) of the Internal Revenue Code of 1954 to their basis in the hands of the transferor-stockholders, and (2) the proceeds of a condemnation award received for other property were not used by taxpayer to "purchase" similar property within the meaning of the nonrecognition-of-gain provisions of Section 1033(a)(3).

STATUTES INVOLVED

The pertinent portions of the statutes involved will be found in the Appendix, _infra_.

STATEMENT

The facts as stipulated by the parties, supplemented by oral testimony, and found by the District Court may be summarized as follows:

There are two taxable periods involved in this suit for refund of federal income taxes. The first is the period beginning January 1, 1959, and ending October 31, 1959, a 10-month period. The second is the period beginning November 1, 1959, and ending October 31, 1960. (I-R. 47; II-R. 707-708.)

The taxpayer, Gyro Engineering Corporation, was incorporated in California in 1952 (I-R. 47, 59-63; II-R. 708) with a total authorized capital stock of ten thousand shares having a stated par value of $1 per share and an aggregate value of $10,000 (I-R. 48, 62-63; II-R. 708, 725). From November 1, 1958, to date the number of issued and outstanding shares of capital stock of taxpayer totaled ten thousand shares (the total authorized capital stock), for which $10,000 was paid and of which 4,950 shares were and are owned by Chris Mowry, 550 shares were and are owned by Chris Mowry's wife (Natalie Mowry), 1,000 shares were and are owned by Patrick Mowry (a son of Chris and Natalie Mowry), 1,000 shares were and are owned by Marilyn Mowry (a daughter of Chris and Natalie Mowry), and 2,500 shares were and are owned by William Mowry (a brother of Chris Mowry). (I-R. 47-49, 84, 89; II-R. 708-709; V-R. 420, 422.) All money "paid in" for the stock issued by

taxpayer and representing the paid-in "capital" of taxpayer from the time of its incorporation throughout the years in suit was simply money deposited in the personal bank account of Chris and Natalie Mowry. Any actual cash representing the paid-in "capital" of taxpayer was supplied by Chris and Natalie Mowry. Thus, no actual cash moved when any stock was "subscribed." Rather, the bank account of Chris and Natalie Mowry simply remained intact.[1/] Indeed, a separate banking account for taxpayer was not opened until February 1, 1962. (I-R. 82-83; II-R. 709, 717-718; V-R. 443.)

The officers of the taxpayer from March 1, 1954, to March 1, 1961, were Chris Mowry (president), William Mowry (vice-president), and Natalie Mowry (secretary-treasurer). The same persons have been the directors of taxpayer from March 1, 1954, to the present. (I-R. 47; II-R. 708.)

From 1953 to and including the years 1959 and 1960, the taxpayer had no payroll in its own name and all payroll checks issued on its behalf were issued on the account of Chris and Natalie Mowry (hereafter sometimes referred to as "transferors"). (I-R. 83; IV-R. 256-257.) No federal withholding tax returns were filed by the taxpayer in 1958, 1959, or 1960. (I-R. 83; II-R. 719.) The federal withholding tax returns for maintenance personnel employed at the transferred buildings were filed in the names of one or another of the Mowrys as employers. No FICA returns were filed by

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1/ William Mowry turned over to Chris Mowry in 1953 a certain business interest, which he had with Chris and Bob Mowry in the French held islands in the South Pacific, for the shares received by him in taxpayer. (I-R. 48-49.)

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taxpayer during the years in suit. (II-R. 719, 720; V-R. 430-432.) No remuneration or fees have been paid to the officers and directors. Further, taxpayer has paid no dividends. (II-R. 720; V-R. 413; VI-R. 488.)

In September 21, 1955, taxpayer acquired title to an unimproved parcel of real property of approximately 70,000 square feet in South Pasadena, California, for $7,800 (hereinafter referred to as the Paloma Street property). (I-R. 49-50, 89; II-R. 709.) With the exception of this purchase, taxpayer was, on the whole, inactive between 1953 and 1959. (I-R. 80-82; II-R. 713-714.) In addition, taxpayer did nothing with the Paloma Street property until 1958, when the County of Los Angeles condemned it. The amount of the compensation, therefore, became the subject of litigation. (I-R. 50; II-R. 709-710.) In late March of 1959, the amount of the award, which was $30,896.65 after attorney's fees, was deposited in the joint account of Chris and Natalie Mowry, which account was also used by taxpayer. (I-R. 50, 86; II-R. 710.) The receipt of the award was not entered in the books of account of taxpayer; indeed there is no evidence that the taxpayer kept any books. (I-R. 86; II-R. 710.)

On January 1, 1959, taxpayer entered into what purported to be a written "sales and purchase agreement" with Chris and Natalie Mowry by which it purported to buy from them three parcels of improved real property consisting of apartment buildings and the land on which they are situated known as The Tropics, The Carousel, and The Orange Grove Circle Apartments, together with certain furniture and

equipment. The total "sale price" was purported to be $3,164,000 payable $30,000 down, the balance of the "sale price" after allowance for existing first mortgages to be evidenced by non-interest-bearing "promissory notes" in a total amount of $2,343,361.50 due in amounts of $30,000 semi-annually. The agreement called for an assignment of rents and management of the properties back to the transferors, exercisable in their sole discretion upon default, the insolvency of the buyer, or the happening of any event which would reasonably be expected to prevent buyer from carrying out its obligation. (I-R. 50-51, 71-75, 86-87; II-R. 710-711, 715-716.) By this, as well as by the informal control exercised by them, the transferors retained many of the same rights to manage the property, and to enjoy its income, that they had before the "sale." (II-R. 716.) Indeed, Chris Mowry, one of the transferors, dealt for all practical purposes for the taxpayer as he would for himself, and paid little heed to the amenities of doing business through the corporate form. As a practical matter, he dealt with the assets and business of taxpayer as he did with his own assets and business. No evidence was introduced to show that taxpayer was held out to third parties as the owner of the land or apartment buildings after the transfer and through the years in suit. (II-R. 721, 723.)

Taxpayer never had a telephone listed in its own name. Telephone listings have been maintained in either the name of the respective transferred apartments or in the name of the manager of each. (I-R. 83; II-R. 719.) The telephone, the expenses for which the taxpayer included among its business expenditures deducted on its tax return for the years in suit, was located in the personal apartment of the transferors and was listed in their name. (II-R. 719; V-R. 452; VI-R. 501-503.) For all practical purposes taxpayer maintained no office or formal place of business other than the residence of the transferors. (I-R. 82; II-R. 719.)

A deed evidencing the transfer of the apartment buildings to taxpayer was executed by Chris and Natalie Mowry, but was not recorded in the office of the County Recorder until March 17, 1961. Despite the fact that Chris Mowry testified that he had been involved in a number of sales and purchases of real property prior to the year 1959 and that he knew of the requirement for purchase of internal revenue documentary stamps on sales of real property, no internal revenue documentary stamps were placed upon the deed which transferred The Tropics, The Carousel, and The Orange Grove Circle Apartments to the taxpayer and no such stamps were purchased. (I-R. 88; II-R. 721; V-R. 348; VI-R. 485.)

At the time of the transfer, taxpayer had little or no cash or working capital, although it did expect to receive the then unliquidated amount of the condemnation award in the future. Taxpayer did

not have enough cash to make the down payment recited in the "sales agreement", and did not borrow cash for the down payment from any sources other than the transferors. (I-R. 50, 81-82, 86; II-R. 714-715; V-R. 347-348, 355, 422-426.) The condemnation award from the Paloma Street property was not received by taxpayer until March 20, 1959. (I-R. 50, 86; II-R. 715.) Therefore, no cash changed hands at the time of the transfer.

At the time that the "sales agreement" was framed, the only immediately foreseeable source of income to taxpayer was the rental income from the apartments to be transferred, and the parties must have intended that the apartment rentals would be used to make the payments on the notes. Indeed, such semi-annual "payments" as were "made" were made from such rental income. (I-R. 87; II-R. 716.) After the transfer, all of the taxpayer's funds were deposited in the personal general bank account of the transferors. Monies "paid" to the transferors as "sellers" of the apartments were not withdrawn but were simply represented by funds already in their personal account, which account was also used by taxpayer. (I-R. 82-83; II-R. 716-717; V-R. 443.) No book entries reflecting such payments were made by taxpayer; the taxpayer produced no books. (II-R. 716.)

Not only were the funds of the taxpayer mingled with those of the transferors, but the tax bills of taxpayer were billed to the transferors personally and all bills were paid by their personal checks. (II-R. 718, 720; IV-R. 250-251; V-R. 362, 450-455; VI-R.

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494-496.) At least some of the checks in evidence were clearly for personal expenses of the Mowrys, yet they were included by taxpayer as its expenditures for which tax deductions were claimed for the years in suit. (II-R. 720; V-R. 450-455; VI-R. 494-496.) None of the leases executed in 1959 and 1960 on the apartments in the transferred buildings were executed in the name of the taxpayer as lessor; nearly all were in the name of Chris Mowry, one of the transferors, as lessor. (I-R. 89; II-R. 718.)

In connection with the transaction of January 1, 1959, the transferors sought the advice of tax counsel. (I-R. 89; II-R. 723-724.)

The Internal Revenue Service began its audit of the taxpayer's returns in early 1961. (I-R. 92.) After the transferors were notified of the audit (V-R. 344), they got in writing the appraisals for the fair market value of the property (II-R. 721-722; VI-R. 433), began to cause the taxpayer to issue leases in its name (II-R. 722; VI-R. 486-487), and opened a bank account for the taxpayer (I-R. 83). In addition, they recorded the deed of transfer. (II-R. 721.)

"Payments" on the "notes" given in the transfer involved were stopped in 1963. No "payments" have been made since. (I-R. 87; II-R. 725.) Moreover, the transferors took no steps to cause taxpayer to enforce their payment when "default" occurred. (II-R. 725; V-R. 438-443.) Taxpayer did pay on the notes that it owed to persons other than the transferors. (V-R. 439-440.) Chris Mowry testified that if additional financing were to be obtained by taxpayer, it

would be necessary for the transferors to subordinate taxpayer's "indebtedness" to them to any such loan. He further testified, with reservation, that he would be agreeable to such subordination. (II-R. 725; V-R. 345.)

By the transaction the transferors purported to sell property allegedly worth $3,164,000 on terms of less than one percent down (although, as noted above, even the alleged down payment of $30,000 was not made at the time of the transfer) and non-interest bearing payments of $60,000 per year over forty years. Even if all the scheduled semi-annual payments on the non-interest bearing notes had been timely made, the notes would not have been paid off for 39.03 years, or until the year 1999. (I-R. 50, 72, 86-87; II-R. 715.) The ratio of debt to equity at the time of the transfer was 316.4 to 1. Even if the amount of the condemnation award, which was not received as of January 1, 1959, were included, the debt-equity ratio would be about 100 to 1. (II-R. 725.)

Neither Chris nor Natalie Mowry was discharged or released by the mortgagees from their obligations under the first mortgages existing on the transferred properties when the properties were transferred to taxpayer. (I-R. 88; II-R. 722.)

The transferors had constructed the above-mentioned transferred apartment buildings in the early 1950's and had depreciated them under the so-called "accelerated depreciation" provisions of the Internal Revenue Code. The adjusted basis for purposes of depreciation of the three apartment buildings to the transferors immediately

prior to the sale was $805,222.09. (I-R. 51, 89-91; II-R. 711.) After the sale, taxpayer on its federal income tax returns for 1959 and 1960, as well as later years not in suit, depreciated the apartment buildings upon the basis of the "sale" price of $3,164,000, allocating a total cost of $2,745,300 to the three buildings exclusive of furniture, equipment and land. (I-R. 51, 53, 54-55; II-R. 711-712.)

By virtue of the use of this "stepped-up basis" for computing its federal tax deductions for depreciation, the depreciation deductions cancelled out all of the taxable income of the taxpayer (consisting almost exclusively of rental income from the apartment buildings) for the years in suit. In addition, the transferors reported capital gain on the "sales" price on the installment basis, all of which gain was offset by claimed losses from a farming venture. (I-R. 88; II-R. 712.)

The taxpayer also claimed nonrecognition-of-gain treatment pursuant to Section 1033 of the 1954 Internal Revenue Code for the condemnation award on its federal income tax return for 1959, based upon its contention that the proceeds of the condemnation award were used to "purchase" similar property within the terms of Section 1033 of the Code by means of the January 1, 1959, transaction whereby it "purchased" the Tropics, Carousel, and Orange Grove apartments. In other words, the $23,096.65 gain (excess of $30,896.65 award proceeds over $7,800 basis) from the condemnation of the Paloma Street property was not reported on the taxpayer's 1959 federal income tax

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return. Instead, taxpayer deducted the gain from what it alleged to be the cost basis of the Orange Grove Circle Apartments on its 1959 federal income tax return. (I-R. 54, 86; II-R. 712.)

In deficiency notices for the taxable years 1959 and 1960, issued December 24, 1963, the Commissioner of Internal Revenue, inter alia, denied taxpayer the "stepped-up basis" for depreciation, determined that taxpayer must use its transferors' basis for depreciation, and likewise denied taxpayer nonrecognition-of-gain treatment on the condemnation award, on the ground that in substance and for federal income tax purposes, the transfer was not a bona fide sale, but rather was a contribution to taxpayer's capital. (I-R. 92, 103-109; II-R. 713.) Taxpayer paid the deficiencies asserted in the statutory notices plus interest on April 30, 1964, and filed its claim for a refund with the Internal Revenue Service on October 5, 1964. (I-R. 92-93.) Taxpayer filed its suit for refund in the District Court on August 2, 1965, or more than six months after filing its claim for refund. (I-R. 2, 93.) On August 25, 1965, its claim for refund was officially rejected. (I-R. 93.)

In this suit for refund the District Court sustained the Commissioner and found, inter alia, that the purported sale was in no sense a bargained or arm's length transaction (II-R. 723), that the transaction was principally "tax motivated", that the transfer was little more than a paper tax device or "gimmick" (II-R. 724), that the recited "price" for the transferred buildings was excessive in relation to their fair market value, and that the taxpayer presented

no credible evidence to indicate that an outside investor would have entered into this transaction. (II-R. 726.) From that adverse decision and the court's judgment entered in accordance therewith (II-R. 752), the taxpayer appeals (II-R. 754).

SUMMARY OF ARGUMENT

The basic question presented is whether the 1959 transfer of three apartment buildings (Tropics, Carousel, Orange Grove) to the taxpayer corporation by its controlling stockholders (the Mowrys) constituted for federal income tax purposes a genuine sale (as taxpayer contends), or a contribution to its equity capital (as the Government contends and the District Court concluded). Upon the answer to this single essentially factual question depends both the proper depreciation basis of the transferred properties, and taxpayer's right to nonrecognition-of-gain realized on condemnation of its other property (Paloma Street). If as the District Court found the transfer was in reality a contribution to capital, not a <u>bona fide</u> sale, then under 1954 Code Section 362(a)(2) (and corollary sections 118, 167(f), and 1011-1012) taxpayer is not entitled to use a stepped-up "sale" price as its basis for depreciation of the transferred properties, as it claims, but must carry over the stockholder-transferors' basis. Nor is taxpayer entitled (as it also claims) to the nonrecognition-of-gain benefit of Section 1033 on the condemnation of the Paloma Street property, since that Section requires (among other conditions precedent) that the proceeds of the condemnation award be used to "purchase"

similar property.

The record fully supports the District Court's conclusion that the purported sale was in substance a contribution to taxpayer's capital. It is settled by numerous decisions of this and other courts that whether a transfer of property by stockholders to their corporation constitutes for federal income tax purposes a contribution to its equity capital, or a sale (or loan), depends on the substance rather than the form of the transaction. That "notes" are taken by the stockholders from the corporation, and that the transaction is labelled a "sale", are not determinative of whether the purported sale is in reality a capital contribution and the notes representative of true indebtedness. Whether the notes create true indebtedness (a creditor interest) resulting from a _bona fide_ sale, as distinguished from a proprietary (stockholder interest) resulting from a capital contribution hinges upon a variety of relevant factors laid down by the courts, no single factor being conclusive. It is equally settled that where (as here) the transaction is not at arm's length, but between a corporation and its controlling stockholders, it is subject to special scrutiny lest what is in reality a capital contribution be disguised as a sale (or loan); that the issue is one of ultimate fact; and that the trial court's conclusion as to the substance and true nature of the transaction, based upon consideration of the relevant factors, is entitled to affirmance unless clearly erroneous.

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As is plain from its opinion (Findings and Conclusions), the District Court properly looked through form to the substance of the transaction in question. Applying the established criteria, and after carefully considering the entire record, it concluded that the transfer constituted a capital contribution to taxpayer corporation, not a bona fide sale. Far from being clearly erroneous, as taxpayer contends, the District Court's conclusion is amply supported--indeed demanded--by the record. Among the features supporting its conclusion are: at the time of the "sale" the taxpayer corporation was in a moribund state, without substantial assets, and the property "sold" to it consisted of capital assets essential to revival of its operations; the "notes" taken by the stockholders were unsecured; they bore no interest; payment of principal was contingent upon the fortune of the enterprise; the stockholder-"noteholders" made no effort to enforce payment of the "notes"; the due date for payment was postponed; the "notes" were in fact subordinated to claims of outside creditors; the corporation was "thinly" capitalized, the debt equity ratio being about 100 to 1; the stockholder-"noteholders" continued to manage the taxpayer's affairs in the same manner as before, and continued as before to mingle its funds with their own; the "sale" price was much greater than the fair market value of the transferred property; third parties acting at arm's length would not have entered into a sale upon the terms and conditions of the "sale" to taxpayer by its stockholders; the dominant purpose of transferring the property in

the form of a "sale" was tax avoidance, i.e., to obtain a stepped-up basis for the property; after internal revenue agents began to audit taxpayer's returns the stockholders attempted to "dress up" the "sale". Any one of the foregoing features would suffice to warrant the District Court's conclusion that taxpayer had failed to meet its burden of proving that the transfer was a bona fide sale, rather than a contribution to its equity capital. Viewed in combination they furnish solid support for that conclusion.

Taxpayer does not and cannot point to any authority which warrants--much less requires--reversal of the decision below. Each case in this field turns as it must on its own facts, and the cases upon which taxpayer relies are readily distinguishable. If any comparison is to be drawn between this case and others involving a similar question, then we submit that the instant case bears a closer resemblance to the many in which the purported sale has been held to constitute a capital contribution than to the isolated few upon which taxpayer relies.

ARGUMENT

The taxpayer corporation claims a stepped-up depreciation basis for three apartment buildings transferred to it by its controlling stockholders (the Mowrys) on January 1, 1959, on the theory that the transfer constituted a "sale" of the properties. See 1954 Code

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Section 362(a), Appendix, *infra*, and Sections 167(f), and 1011-1012.[2/] It also claims that gain realized on the condemnation of its Paloma Street property is not recognizable, on the same theory, i.e., that the condemnation award proceeds were used to replace the condemned property by "purchase" of the apartment buildings. See Section 1033, Appendix, *infra*.[3/]

2/ Code Section 167(f) (after 1961 redesignated Section 167(g)) fixes the basis for depreciation of property at the adjusted basis provided in Section 1011 for determining gain or loss in its sale or other disposition. Section 1011 provides that the adjusted basis for determining gain or loss is the basis determined under Section 1012, which in turn provides that the basis shall be cost, "except as otherwise provided in this Subchapter and subchapter (C) * * *." One of the exceptions is contained in Section 362 of subchapter C, relating to "Basis to Corporations." Section 362(a)(2) provides that if property was acquired by a corporation "as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." Corollary Section 118, Appendix, *infra*, excludes from gross income of a corporation contributions to its capital.

An analogous "basis" question is presented under Code Section 362(a)(1), where property is transferred to a corporation in a transaction to which Section 351 applies, i.e., a tax-free transfer by controlling stockholders in exchange for stock or securities of the transferee corporation. See e.g., *Truck Terminals, Inc. v. Commissioner*, 314 F. 2d 449 (C.A. 9th, 1963); *Aqualane Shores, Inc. v. Commissioner*, 269 F. 2d 116 (C.A. 5th, 1959) (involving the predecessor sections of the 1939 Code).

3/ Section 1033 permits nonrecognition-of-gain upon the "involuntary conversion" of property (including its condemnation) if within a specified period taxpayer "purchases other property similar or related in service or use to the property so converted."

It is the Government's position, sustained by the District Court, that the "sale" theory upon which both claims rest is untenable, because the purported sale in substance constituted a contribution to taxpayer's capital. If as the District Court concluded the transaction was in reality a capital contribution, not a sale, then it follows that taxpayer is required by 1954 Code Section 362(a)(2) to carry over the transferor-stockholders' basis for depreciation purposes, and that it is not entitled to the nonrecognition-of-gain benefit of Section 1033.[4/] We submit that the District Court's decision upholding the Government's position is clearly correct and entitled to affirmance.

I

THE RECORD FULLY WARRANTS THE DISTRICT COURT'S CONCLUSION THAT THE TRANSFER TO TAXPAYER CORPORATION BY ITS CONTROLLING STOCKHOLDERS WAS IN SUBSTANCE A CONTRIBUTION TO ITS CAPITAL, NOT A *BONA FIDE* SALE, WITH THE RESULT THAT TAXPAYER WAS REQUIRED BY 1954 CODE SECTION 362(a)(2) TO CARRY OVER AS ITS BASIS FOR THE TRANSFERRED PROPERTY THE BASIS IN THE HANDS OF THE TRANSFEROR-STOCKHOLDERS

4/ Taxpayer's reliance (Br. 13-23) on Section 1239 is manifestly misplaced. That Section requires gains from sales of depreciable property between spouses or between a stockholder and a controlled corporation to be taxed as ordinary income rather than as capital gain, and does not come into play unless there is a *bona fide* sale. To assume that the instant transfer is to be tested by the provisions of Section 1239 is to beg the very point at issue--whether it constituted a *bona fide* sale *or* a capital contribution. In other words, we are not here concerned with whether the claimed "sale" is the kind denied capital gain benefit by Section 1239, but with whether it was really a sale at all.

A. The District Court applied the relevant factors in determining whether the transfer was in reality a contribution to capital or a bona fide sale

It is axiomatic that the substance of a transaction, rather than its form, controls the tax consequences. The labels put upon the transaction may be disregarded if they do not conform to what actually took place.[5/] Gregory v. Helvering, 293 U.S. 465 (1935); Griffiths v. Commissioner, 308 U.S. 355 (1939); Higgins v. Smith, 308 U.S. 473 (1940); United States v. Mattison, 273 F. 2d 13 (C.A. 9th, 1959); Factor v. Commissioner, 281 F. 2d 100 (C.A. 9th, 1960), certiorari denied, 364 U.S. 933 (1961); Wolf v. Commissioner, 357 F. 2d 483, 485 (C.A. 9th, 1966); Goldstein v. Commissioner, 298 F. 2d 562 (C.A. 9th, 1962); Truck Terminals, Inc. v. Commissioner, 314 F. 2d 449 (C.A. 9th, 1963); Zimmerman v. United States, 318 F. 2d 611 (C.A. 9th, 1963); Aqualane Shores, Inc. v. Commissioner, 269 F. 2d 116 (C.A. 5th, 1959).

5/ Use of the words "purchase" and or "sale" in the Stipulation of Facts (and the District Court's Findings) obviously was never intended, as taxpayer suggests (Br. 23-29), to concede that the transaction in question was a bona fide sale for federal income tax purposes, rather than a contribution to taxpayer's capital. These labels were employed below (and again here) merely for convenience, to indicate only what the parties purported to do. (II-R. 479-481, 727.) To subscribe to taxpayer's self-serving interpretation of the stipulation is to attribute to the Government a concession of the very issue which gave rise to this litigation; indeed, it would render this case moot. Plainly, the Government has not "stipulated" its case away.

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In making a determination whether there is a true sale of property to a corporation or a contribution to its capital, the courts have laid down a number of factors to be considered. In O. H. Kruse Grain & Milling Co. v. Commissioner, 279 F. 2d 123, 125-126 (C.A. 9th, 1960), this Court said:

> There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money; (11) the ability of the corporation to obtain loans from outside lending institutions.

See also, Peterson v. Commissioner, 380 F. 2d 1 (C.A. 1967); Truck Terminals, Inc. v. Commissioner, supra; Goldstein v. Commissioner, supra; Zimmerman v. United States, supra.

Factors considered by other courts in addition to the ones cited in O. H. Kruse Grain & Milling Co. v. Commissioner, supra, include the following: (1) whether the transfer had a business purpose; (2) whether the "price" of the properties, for which the notes were issued, was disproportionate to the fair market value of such properties; (3) whether the note holders, when default of the notes occurred, attempted to enforce the obligation; (4) whether

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there was an absence of security; (5) whether assets were essential for the conduct of the corporate business; (6) whether the purported indebtedness was incurred to acquire capital assets; (7) whether there is an inordinately postponed due date; (8) whether there was confusion of the personal activities of transferor-stockholder with the activities of the corporation; (9) whether there was non-payment of interest, (10) whether there was a failure to insist upon payment until the corporation could "afford it"; (11) whether the note could reasonably be expected to be repaid only out of profits of the enterprise; and (12) whether the transfer was a result of arm's length bargaining.[6/]

6/ Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), affirmed 365 F. 2d 24 (C.A. 7th, 1966), certiorari denied, 385 U.S. 1007 (1967); Kolkey v. Commissioner, 27 T.C. 37 (1956), affirmed 254 F. 2d 51 (C.A. 7th, 1958); Foresun, Inc. v. Commissioner, 348 F. 2d 1006 (C.A. 6th, 1965); Wood Preserving Corp. of Baltimore v. United States, 347 F. 2d 117 (C.A. 4th, 1965); Moughon v. Commissioner, 329 F. 2d 399 (C.A. 6th, 1964); Jewell Ridge Coal Corp. v. Commissioner, 318 F. 2d 695 (C.A. 4th, 1963); McSorley's Inc. v. United States, 323 F. 2d 900 (C.A. 10th, 1963); Montclair, Inc. v. Commissioner, 318 F. 2d 38 (C.A. 5th, 1963); Nassau Lens Co. v. Commissioner, 308 F. 2d 39 (C.A. 2d, 1962); P. M. Finance Corp. v. Commissioner, 302 F. 2d 786 (C.A. 3d, 1962); United States v. General Geophysical Co., 296 F. 2d 86 (C.A. 5th, 1961), certiorari denied, 369 U.S. 849 (1962); Brake & Electric Sales Corp. v. United States, 287 F. 2d 426 (C.A. 1st, 1961); Aqualane Shores, Inc. v. Commissioner, supra; Gilbert v. Commissioner, 262 F. 2d 512 (C.A. 2d, 1959), certiorari denied, 359 U.S. 1002 (1959); Camp Wolters Enterprises v. Commissioner, 230 F. 2d 555 (C.A. 5th, 1956), certiorari denied, 352 U.S. 826 (1956); Gooding Amusement Co. v. Commissioner, 236 F. 2d 159 (C.A. 6th, 1956), certiorari denied, 352 U.S. 1031 (1957).

The above factors are not exclusive. Indeed, this Court so recognized when it said in Kruse, supra, that there were "at least" eleven factors. See also Truck Terminals, Inc., supra. Contrary to taxpayer's assertion (Br. 65-68), the District Court considered the relevant factors in reaching its conclusion. Its consideration of taxpayer's attempt to "dress up the transaction", after it was questioned by the Internal Revenue agent, was clearly relevant when considered along with other relevant factors. Whether the transferred assets were necessary to revive a moribund corporation is essentially the same factor as whether the assets are required for the commencement of the corporate business. Further, whether there is an absence of a sinking fund is essentially the same criterion as whether the note could reasonably be expected to be paid by maturity out of profits. And whether there is a business purpose for the transaction or whether the only purpose is to avoid taxes is to restate the same factor in two different ways.

Subjective intent of the parties does not control; rather, it is the actual intent, which is to be objectively ascertained by looking beneath mere form to all relevant facts and circumstances. O. H. Kruse Grain & Milling Co. v. Commissioner, supra; Truck Terminals, Inc. v. Commissioner, supra; Wilbur Security Co. v. Commissioner, 279 F. 2d 657 (C.A. 9th, 1960); Camp Wolters Enterprises v. Commissioner, 230 F. 2d 555 (C.A. 5th, 1956), certiorari denied, 352 U.S. 826 (1956). As to the essential difference between

a creditor and a stockholder, this Court said in Wilshire & West Sandwiches v. Commissioner, 175 F. 2d 718, 721 (1949), that the stockholder intends to make an investment and take the risks of the venture, while the creditor seeks a definite obligation, payable in any event. Thus, in order for there to have been a sale, the transferor must actually become a creditor, that is acquire an absolute right to a fixed sum at a fixed maturity date, repayable in any event. As the Second Circuit stated in Gilbert v. Commissioner, 248 F. 2d 399, 402 (1957):

> The classic debt instrument is an unqualified obligation to pay a sum at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof.

No single factor is decisive. Rather, the trial court must weigh the relevant factors together in determining whether the transfer of property was a sale or a contribution to capital (Moughon v. Commissioner, 329 F. 2d 399 (C.A. 6th, 1964)), and each case must be considered on its own facts.

The Commissioner's deficiency determination is presumptively correct and the burden is on the taxpayer in a refund suit not only to prove the Commissioner's determination to be erroneous, but to establish the exact amount of tax allegedly overpaid. Lewis v. Reynolds, 284 U.S. 281 (1932); Roybark v. United States, 218 F. 2d 164 (C.A. 9th, 1954); United States v. Pfister, 205 F. 2d 538 (C.A. 8th, 1953); David v. Phinney, 350 F. 2d 371 (C.A. 5th, 1965);

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Missouri Pacific Railroad Co. v. United States, 338 F. 2d 668 (Ct. Cl. 1964). The Supreme Court in Lewis v. Reynolds, supra, p. 283, said that a refund suit is an action for money had and received, and stated "it is incumbent upon the claimant to show that the United States has money which belongs to him." 7/

B. The record amply supports the District Court's conclusion that the transfer was in reality a contribution to taxpayer's capital, not a bona fide sale

As pointed out above, no one factor is conclusive in determining whether the transfer was a contribution to capital or a sale; rather, the factors must be weighed together. As long as there is evidence to support the factual determination of the District Court on this issue, even though there be some evidence that could have

7/ The cases on which the taxpayer relies involved deficiency redetermination proceedings in the Tax Court, where the question is whether the Commissioner's deficiency notice is correct, and not refund suits in the District Court, where the taxpayer must prove that the Government owes him money. The Supreme Court emphasized this difference in Helvering v. Taylor, 293 U.S. 507, 514-515 (1935). See also David v. Phinney, supra; and Commissioner v. R. J. Reynolds Tobacco Co., 260 F. 2d 9, 15 (C.A. 4th, 1958).

Equally unfounded is taxpayer's assumption (Br. 51) that the Government is precluded from asserting new defenses in support of the assessment. The Government may raise any defense at trial to show that it has not over-collected the tax due from the taxpayer. Lewis v. Reynolds, supra, p. 283; United States v. Pfister, supra, pp. 541-542; Blansett v. United States, 283 F. 2d 474, 478 (C.A. 8th, 1960). In Blansett, supra, p. 478, the court said that "a deficiency assessment may be sustained upon any legal ground supporting it, even though the Commissioner did not rely thereon when the assessment was made. If the assessment is right on any theory it must be sustained." The statute of limitations bars only "the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded." Lewis v. Reynolds, supra, p. 283.

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supported a contrary decision, its decision must be affirmed. E.g., O. H. Kruse Grain & Milling Co. v. Commissioner, supra; Truck Terminals, Inc. v. Commissioner, supra.

After listing the factors which the courts have considered relevant in determining whether or not a transfer of property is a contribution to capital or a sale, the District Court analyzed the evidence which impelled it to conclude that the transfer was a contribution to capital. It considered the following factors:

(1) There was an absence of interest on the notes and agreement transferring the apartment buildings to the taxpayer. (I-R. 86; II-R. 710, 740; V-R. 438.)

(2) No due date was stated in the transfer documents; 1999 or 39.03 years from the date of transfer was the earliest date on which the notes would be paid off if all the payments were met on time, which was not the case. (I-R. 87.)

(3) The alleged indebtedness was incurred to acquire necessary capital assets and to revive the corporation from its essentially moribund state. Clearly it could not have gone into a new line of business (the acquisition of apartment buildings) on the scale which this transfer made possible without these assets. At the time of the transfer, the taxpayer had on hand an unliquidated claim against the County of Los Angeles for the Paloma Street property, which the county had condemned, and a small amount of cash. The claim against the county was settled for $30,896.65 plus attorney's fees

on March 20, 1959, nearly three months after the transfer.[8/] Between 1953 and 1959, the only activity undertaken by taxpayer was the purchase of the Paloma Street property. (I-R. 50, 80-82, 86, 89.) Further, on its California tax returns filed between 1952 and 1958 the taxpayer claimed to be inactive, did not file federal income tax returns between 1952 and 1958, and on its 1959 federal income tax return stated that it was inactive from 1956 to 1958. (I-R. 82.) Contrary to the taxpayer's claims (Br. 54-55, 61), findings of fact No. 20 (II-R. 713) (that the taxpayer was "substantially" inactive), and No. 43 (II-R. 724) (that the transfer was essential to get taxpayer active), are well supported by the evidence.[9/]

8/ The taxpayer's contention (Br. 55) that finding of fact No. 23 (II-R. 714-715) is clearly erroneous is without merit, for the finding sets forth that at the time of the transfer there was an unliquidated claim and little cash or working capital. Evidently cash and working capital are used synonymously. At the date of incorporation, $10,000 was given for taxpayer's stock. From this money, $7,800 was used to purchase the Paloma Street property, and some money was used in 1952 and 1953 in an unsuccessful business venture. Therefore, very little money could have been on hand in 1959 for no additional money was contributed to the taxpayer. At the most there was $1,850 in cash in the taxpayer. (I-R. 48-50; V-R. 422; VI-R. 489.)

9/ It is clear that the making of Scorby test equipment and test panels was abandoned by early 1953. (I-R. 80.) Further, it is not clear when taxpayer undertook its other testing. (IV-R. 239-240.) Whatever it might have done between 1953 and 1958 did not amount to much activity. Thus, to say "substantially" inactive is correct.

(4) The transferors failed to press for the payment on the "notes" when the taxpayer defaulted on them in 1964, even though taxpayer continued to pay its other creditors. (V-R. 435-437, 438, 439-440.) Thus, as the District Court found (I-R. 725), there was a subordination of the notes in fact.[10]

(5) There was no security behind these notes, except for the assignment of rents in event of default. (I-R. 71-72.) Nor was any sinking fund provided to assure payment by the maturity date.

(6) The debt-equity ratio immediately after the transfer was grossly disproportionate. Even if the money receivable from the city were considered, the ration was about 100 to 1. If one did not consider the value of this unliquidated claim, the ratio would be 316.4 to 1. Thus, finding of fact No. 46 (II-R. 725) is supported by the evidence. Prior to the transfer, the operating capital was

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10/ Further, the court found that Mr. Mowry hedged a little when he said that he would not accept subordination of his notes (V-R. 345):

> The Court: Was this agreeable to you to subordinate?
>
> The Witness: Provided that we got paid the proceeds of the loan. Otherwise no.

Indeed, the court did not believe Mr. Mowry when he indicated that he would not subordinate the notes if the taxpayer needed to obtain additional financing, because in fact he had allowed other creditors of the taxpayer to be paid after 1963 while he did not insist that taxpayer pay him the money due on the notes. Thus finding of fact No. 45 (II-R. 725) is correct.

small in comparison to the burden sought to be undertaken on January 1, 1959, and after the transfer there was an absence of operating capital. Indeed, taxpayer was in no position to make any large investment. (V-R. 421.)

(7) After the transfer, the transferors continued to operate the apartments as before. The funds of the taxpayer and the transferors were commingled in one bank account. (I-R. 82-83; V-R. 443-444.) No books were introduced into evidence to show that the accounts were kept separate. The tax bills were made in the name of the transferors. (V-R. 362.) Leases were executed in the transferors' names through 1959 and 1960. (I-R. 89.) Taxpayer never filled out withholding or FICA tax returns. Rather, these returns were filled out in the name of Mowry. (I-R. 83; V-R. 429-432.) Taxpayer had no separate place of business aside from the apartment or place of abode of the transferors. (V-R. 451-452.) No telephone was listed in the taxpayer's name. (I-R. 83.) Thus findings of fact 8, 12, 28, 29, 30, 31, 32, 33, 34, 37, and 39 (II-R. 709, 710, 716-721, 722-723), which the taxpayer challenges (Br. 51-52, 55-59), are all clearly supported by the evidence (V-R. 429-432, 443; VI-R. 496-499), and show clearly that the taxpayer was little more than the transferors' hip-pocket corporation.

(8) When the Commissioner began to check on the taxpayer's returns for 1959 and 1960, the transferors attempted to dress up the transaction. The audit of its returns began in early 1961. (I-R. 92.) The transferors then recorded the deed transferring the

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property in the office of the County Recorder (I-R. 88), obtained for the first time written appraisals for the fair market value of the property (V-R. 433), began to cause the taxpayer to issue leases in its name (VI-R. 486-487), and opened a bank account for the taxpayer (I-R. 83). Although Chris Mowry testified that he recieved word of the Commissioner's audit in the late spring of 1961 (about six weeks after the recordation of the deed of transfer) (V-R. 344), the court disbelieved him. See finding of fact No. 36 (II-R. 721-722).11/

(9) The transfer had little or no purpose other than to avoid taxes, i.e., to generate a stepped-up basis for depreciation. See Findings No. 16, 41, 42 (II-R. 712, 723-724). The transfer was a "hollow tax device or 'gimmick'." (II-R. 745.) The trial court was under no obligation to believe the self-serving testimony of Chris Mowry as to why the transfer took place. Foresun, Inc. v. Commissioner, 348 F. 2d 1006 (C.A. 6th, 1965); United States v. General Geophysical Co., 296 F. 2d (C.A. 5th, 1961), certiorari denied, 369 U.S. 849 (1962). Thus, the use of the words "sale" and "purchase" to describe the transfer is a misnomer, the transfer being in reality a contribution to capital.12/

11/ Mowry testified that he did not remember who asked him to get the written appraisal. (V-R. 433; cf. page 58 of taxpayer's brief, which says that Mowry got the appraisal at the request of an Internal Revenue Agent). The agent's report is prepared long after the audit has begun.

12/ The Government's position is not that the transfer was a sham, as taxpayer argues (Br. 41-42), but that the "sale" label attached to the transaction by the parties is not determinative of its substance and tax effect.

(10) The price set forth in the transfer documents was in excess of its fair market value. The taxpayer's own valuation expert testified that the fair market value was $2,975,000, or about $189,000 less than the price ($3,164,000) set forth in the "sale" documents. (III-R. 77, 86, 91.) The Government's expert witness testified that the fair market value was $2,415,000, or $749,000 less than the "sale" price. (V-R. 558.) Under the capitalization-of-income approach -- considered by taxpayer's expert to be "the most significant" valuation method (III-R. 61-96), the fair market value was found by taxpayer's expert to be $2,427,750, or $12,750 more than the Government's expert's valuation. Thus the price recited in the "sales and purchase" agreement (I-R. 71-72) was about 30 per cent in excess of the fair market value. See finding of fact No. 47. (II-R. 726.)

(11) The "down payment" (which was not paid on the date of the transfer) was less than one per cent (I-R. 71-72; II-R. 715); although Mr. Mowry knew of the requirement to place internal revenue documentary stamps on <u>sales</u> of real property, he failed to do it (V-R. 348; VI-R. 485); the transferors were not discharged from their personal obligation on the first mortgages (I-R. 88; II-R. 722); and the transferors continued to manage the property after the transfer as they had managed it before (II-R. 717).

(12) The transaction did not take place at arm's length, but was between a corporation and its controlling stockholders. In the words of the District Court, "the whole transaction seems unrealistic and uneconomic", and "no credible evidence was presented by plaintiff

[taxpayer] to indicate [that] outside investors would have entered into this transaction in the form and manner of execution it took." (II-R. 726.)

Taxpayer does not and cannot point to any authority which indicates reversible error in the decision below. Commissioner v. Brown, 380 U.S. 563 (1965), upon which it apparently chiefly relies (Br. 30-41), presented an issue far removed from that here presented, namely, whether an arm's length transfer of stock for a consideration measured by the transferee's earnings from the transferred property constituted a sale resulting in capital gain, as distinguished from a mere license resulting in ordinary income.13/ Rather the issue here is similar to that decided by this Court in, for example, O. H. Kruse, supra, and Truck Terminals, Inc., supra, and other cases involving the question of a taxable sale vis a vis a nontaxable exchange or capital contribution (e.g., Aqualane Shores, supra; Kolkey, supra).

13/ Moreover, the facts in Brown were materially different from those of this case. First, the transaction there involved was negotiated only after "considerable good-faith bargaining at arm's length between the Brown family and the Institute." 380 U.S., pp. 568-569; see also pp. 567, 572. Second, "the primary motivation for the Institute was the prospect of ending up with the assets of the business free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property and the money for use in cancer research * * *." 380 U.S., p. 569. The Court stated that this meant that there had been a real shift of economic benefit in the transaction. In the instant case, there was no good-faith bargaining at arm's length (see Reef Corp. v. Commissioner, 368 F. 2d 125 (C.A. 5th, 1966), certiorari denied, 386 U.S. 1018 (1967)), nor was there a real change in economic benefit. Further, in Brown the purchaser was not under the control of the seller, as was the taxpayer herein. Finally, the sellers in Brown took security in the form of mortgages, whereas in the instant case the transferors made no formal security arrangements.

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II

SINCE THE TRANSFER WAS IN SUBSTANCE A CONTRIBUTION TO CAPITAL, NOT A BONA FIDE SALE, IT DID NOT QUALIFY AS A "PURCHASE" WITHIN THE MEANING OF THE NONRECOGNITION-OF-GAIN PROVISIONS OF 1954 CODE SECTION 1033

Section 1033 of the 1954 Internal Revenue Code, Appendix, *infra*, provides that if property has been "involuntarily converted" into money as a result of its condemnation, any realized gain will not be recognized if within a specified period the taxpayer "*purchases* other property similar or related in service or use to the property so converted." (Emphasis supplied.) The legislative policy embodied in this section has been summarized by this Court in the following terms (*Filippini* v. *United States*, 318 F. 2d 841, 844 (1963), certiorari denied, 375 U.S. 922 (1963)):

> The purpose of the statute is to relieve the taxpayer of unanticipated tax liability arising from involuntary condemnation of his property, by freeing him from such liability to the extent that he re-establishes his prior commitment of capital within the period provided by the statute.

Thus, in order to qualify for non-recognition under Section 1033, the taxpayer must have "purchased" property of like kind. Granting that the apartments and the Paloma Street property (the condemned property) were similar or related in service, for the reasons pointed out above (Point I) there was no "purchase" of the apartments with the condemnation proceeds of the Paloma Street property but a contribution of the apartments to taxpayer's capital. There was no

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reinvestment of the condemnation proceeds by the taxpayer within the meaning of Section 1033, for there was no purchase.[14/] See A. A. Gallagher Warehousing Corp. v. Commissioner, decided January 22, 1965 (24 T.C.M. 38), affirmed sub nom. American Truck Rental Corp. v. Commissioner, 355 F.2d 928 (C.A. 3d, 1966).

Moreover, the gain realized on the condemnation of the Paloma Street property cannot qualify for non-recognition for the additional reason that the condemnation proceeds were not used to "purchase" similar property within the meaning of Section 1033(a)(3)(A)(ii), which provides that "the taxpayer shall be considered to have purchased property or stock only if * * * the unadjusted basis of such property or stock would be its cost within the meaning of section 1012." See also Treasury Regulations on Income Tax, Section 1.1033(a)-2(b)(4), Appendix, infra. As we have already shown (Point I, supra), by virtue of Section 362(a) the basis of the replacement property (apartment buildings) to the taxpayer was not its cost, but its basis in the hands of the transferor-stock-

14/ The undisputed facts relating to the condemnation confirm the District Court's conclusion that the proceeds were not used to "purchase" the apartment buildings. It was stipulated that the proceeds were paid to Chris Mowry on March 30, 1959 (I-R.50), and were deposited in the joint bank account of Chris and Natalie Mowry (the same account that was used by the taxpayer) and were not entered in the books of account of the taxpayer (I-R. 86). Presumably the funds remained there indefinitely subject to unfettered control of the taxpayer or Mowry. See Findings Nos. 51 and 52 (II-R. 727).

holder. Therefore, the District Court correctly held that Section 1033 was inapplicable, and that taxpayer was taxable on the gain realized from the condemnation of the Paloma Street property.

CONCLUSION

The judgment of the District Court is correct and should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 11th day of June, 1968.

Robert J. Jones

Assistant United States Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 118. CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION.

(a) General Rule.--In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Cross Reference.--

For basis of property acquired by a corporation through a contribution to its capital, see section 362.

*   *   *

(26 U.S.C. 1964 ed., Sec. 118.)

SEC. 362. BASIS TO CORPORATIONS.

(a) Property Acquired by Issuance of Stock or as Paid-In Surplus.--If property was acquired on or after June 22, 1954, by a corporation--

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

*   *   *

(26 U.S.C. 1964 ed., Sec. 362.)

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) General Rule.--If property (as a result of its * * * condemnation or threat or imminence thereof) is compulsorily or involuntarily converted--

*   *   *

(3) Conversion into money where disposition occurred after 1950.--Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain.--If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. For purposes of this paragraph--

(i) No property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection (c) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012.

(B) Period within which property must be replaced.--The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending--

(i) one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe.

* * *

(26 U.S.C. 1964 ed., Sec. 1033.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.1033(a)-2. Involuntary conversion where disposition of the converted property occurred after December 31, 1950. --

* * *

(c) Conversion into money or into dissimilar property.

* * *

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(c), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 1033(c), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(26 C.F.R., Sec. 1.1033(a)-2.)